Seattle City Light

2023 CITY LIGHT DEBT STRATEGY

EXECUTIVE SUMMARY

Part of implementing City Light's 2023-2028 Strategic Plan is developing an official strategy for developing an optimal mix of funding for the capital plan and managing the growth in overall debt. As part of this process, City Light reviewed its current policies and practices and proposes changes to its rate setting targets and strategies. The proposed changes will provide flexibility when setting rates, ensure adequate annual financial performance and manage the amount of outstanding debt. The proposed changes to the rate setting targets and guidelines include:

1. Updating the target debt service coverage
    - *at least* 1.80x in any given year and the 6-year rolling average greater than 1.90x.
2. Refining the target for funding of the capital plan from operating cash
    - Six-year average operating cash funding greater than 40% of *net* capital requirements.
3. Introducing a leverage target
    - Debt-to-fixed asset ratio less than 60%.
4. Introducing a liquidity target
    - Days cash on hand is greater than 150 days.
5. Allow for temporary flexibility
    - suspension of capital funding and leverage targets is permissible for up to 5 years under exceptional circumstances.

The proposed rate setting targets serve as a minimum backstop to control debt. City Light's specific strategy for the next Strategic Planning period (2025-2030) is to exceed these targets when establishing the rate path. Doing so will further decrease City Light's reliance on debt and also provide more financial buffer if projected capital costs increase in the future. Using City Light's current financial forecast and stress tests indicate that City Light can absorb a significant amount of higher capital costs and still meet the proposed financial targets with only a modest impact to rates.

INTRODUCTION

Producing and delivering electricity to customers requires a significant amount of physical infrastructure, making electrical utilities among the most capital-intensive industries. This infrastructure, designed to last multiple decades, and associated installation require large upfront costs. City Light uses long-term debt as a tool to help spread out the cost recovery of these long-lived assets, which enables it to provide lower and more stable retail rates to its customer-owners.

The two primary ways public utilities fund their capital needs is by paying with operating cash or issuing debt. There is no right mix; each utility must determine how it uses debt based on individual factors, and debt practices may change over time. In general, too much reliance on debt can result in increased borrowing costs or prevent access to the bond market. Too little reliance on debt may disproportionally shift cost recovery for long-lived assets to current customers (i.e., higher retail rates in the near term).

City Light currently has some of the highest credit ratings among public utilities (Aa2 Moody's, AA S&P), providing it access to among the lowest available interest rates. The average effective interest rate over the past decade has been around 3.5%. Low borrowing costs can incentivize carrying a slightly higher debt burden, all else equal.

The City of Seattle has a debt policy that governs the use and terms of issuing debt for all City departments, including City Light. One of the main functions of the City's policy is to outline the legal requirements for issuing debt, such as the type of expenses for which debt may be used. The City's policies do not specifically address managing the Utility's overall debt burden. City Light has financial policies that outline targets for setting rates and sizing the capital program that indirectly manage debt. City Light's current specific financial policies call for: (1) setting rates to achieve 1.80x coverage and (2) managing the size of the 6-year capital program so that funding from operations is 40% or greater.

During City Light's 2023-2028 Strategic Planning process the City Light Review Panel encouraged City Light to develop an official strategy to manage the Utility's growing amount of outstanding debt. In response, City Light included developing a debt strategy as part of its business strategy for ensuring financial health and affordability within the Adopted 2023-2028 Strategic Plan.

City Light has reviewed its current policies and practices around debt issuance and while the current financial policies do a reasonable job at managing debt, they can be augmented in a new framework to improve overall debt management. The proposed debt strategy serves as a guideline for managing the overall amount of outstanding debt, as well as the amount of the capital program that's funded with debt. The strategy establishes debt-related metrics and associated targets used to manage debt. It also allows for flexibility in certain circumstances. The debt strategy is not a comprehensive set of financial policies used to put a ceiling on the size of the capital program but is used within the Strategic Planning framework to help guide the use of debt to achieve the desired balance between service levels and affordability for both current and future customers.

This paper outlines City Light's proposed Debt Strategy. First, it identifies and defines debt-related metrics and selects the optimal mix of metrics to manage to. Then it reviews how select metrics compare to peer utilities. Next, it proposes targets and guidelines for the metrics to be used to manage debt. It then provides an example of how the strategy would work with a significantly larger capital program (i.e., stress test). Finally, it lists the next steps forward.

DEBT RELATED METRICS

There are many types of debt-related metrics that provide context for an entity's outstanding debt amount and its general ability to make debt payments in the short and long run. This section describes some of the different categories of debt-related metrics. It also provides City Light's proposal for what primary metric to track and manage to for each category.

Financial Leverage refers to the relative amount of obligation or debt an entity has. A leverage ratio is a measure of financial leverage and provides a relative level of debt when compared to another financial metric. A leverage ratio helps determine if an entity is carrying too much overall debt based on its individual circumstances. It is important to look at outstanding debt relative to other characteristics because it helps provide context for the size of overall debt based on the size of an entity, often in terms of assets and/or revenues.

Common financial leverage metrics include:

1. Debt-to-Assets Ratio = Total Debt / Total Assets

2. Debt-to-Fixed Assets Ratio = Total Debt / Fixed Assets[1]
3. Debt-to-Equity Ratio = Total Debt / Total Equity
4. Debt-to-Capital Ratio = Total Debt / Total (Total Debt + Total Equity)
5. Asset-to-Equity Ratio = Total Assets / Total Equity

Recommendation: City Light proposes to use Debt-to-Fixed Asset Ratio as its primary leverage metric. All leverage metrics convey a slightly different measurement and no single metric is best for all utilities. The debt to fixed asset ratio most closely reflects the amount of outstanding debt relative to the level of infrastructure currently in service. It provides an approximate measure of the proportion of total infrastructure in service that has been funded with debt and ties closely with the associated Capital Funding Target (discussed later in this section). It is also a metric commonly used by rating agencies.

Coverage refers to an entity's ability to pay its financial obligations. A coverage ratio is a measure of available funds to pay its annual debt obligation. In general, a higher coverage ratio indicates a greater ability for an entity to meet its current financial obligations while a lower ratio indicates a lower ability. A few coverage ratios include:

1. Interest coverage ratio: The ability of an entity to pay its annual interest expense (only) on its debt

   Interest Coverage = Net Revenue / interest expense

2. Debt service coverage ratio: The ability of an entity to pay its annual debt obligations, including repayment of both principal and interest

   Debt Service Coverage = Net Revenue / Debt Service

3. Cash coverage ratio: The ability of an entity to pay its annual interest expense with its cash balance

   Cash Coverage = Cash / interest expense

Recommendation: City Light proposes continuing to use debt service coverage ratio as its primary coverage metric. This metric is the mostly widely used in public power and is also the primary coverage metric used by rating agencies.

Liquidity refers to funds that can be made readily available to satisfy ongoing cash flow requirements, including debt. Some common types of liquidity metrics include:

Current Ratio = Current Assets / Current Liabilities

Quick Ratio = (Cash + Accounts Receivables + Marketable Securities) / Current Liabilities

Days Cash on Hand[2] = Unrestricted Cash / ((Annual Operating Expenses – Depreciation) / Days in Year)

Recommendation: City Light proposes to continue to use days cash on hand (DCOH) as a primary liquidity metric since it is the most common liquidity metric used by rating agencies. This metric does not count the City's cash pool that is available to City Light for 90 days in an emergency without legislation and longer with legislation.

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[1] Fixed Assets generally include undepreciated plant. City Light also includes Construction Work in Progress to smooth out the impacts of large projects.
[2] City Light, Moody's and S&P include the RSA as unrestricted cash for the purposes of calculating this metric.

Capital Funding Target measures the percentage of the capital program funded with operating cash. The City of Seattle does its capital planning on a 6-year basis, so this funding target is a 6-year metric that corresponds to the planning timeframe. The measure evaluates how much of the net capital requirements (i.e., the amount City Light is responsible for funding) are funded by operating cash and how much is funded by issuing debt. The capital funding target is closely related to the debt-fixed-asset ratio as they both measure the relative level of debt to the capital.

The calculation is as follows:

Capital Funding = Funding from Operations / (Total Capital Requirements – 3rd Party Capital Contributions)

Summary
City Light's proposed debt-related financial metrics are:

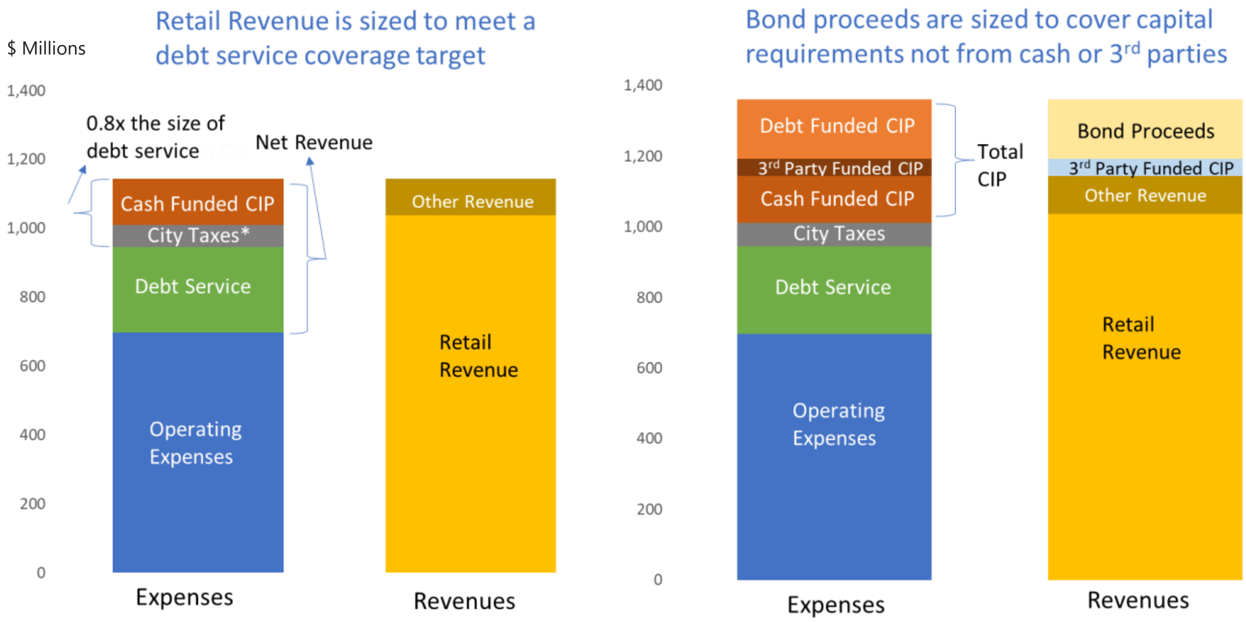
1. Debt Service Coverage
2. Debt-to-fixed assets ratio
3. Days Cash on Hand
4. Percentage of capital funding from operations (over 6 years)

HOW THE PROPOSED FINANCIAL METRICS ARE RELATED

City Light's proposed metrics are inter-related. The most notable relationship is debt service coverage and cash funding of the capital program as the debt service coverage level drives the amount of operating cash available for the capital program. Net Revenue is the difference between operating revenues and operating expenses. After Net Revenue is used to pay debt service and City taxes[3], the residual is used for cash funding of the capital program. Bond proceeds are sized to cover the remainder of capital requirements. Figure 1 shows an example that helps illustrate this this relationship.

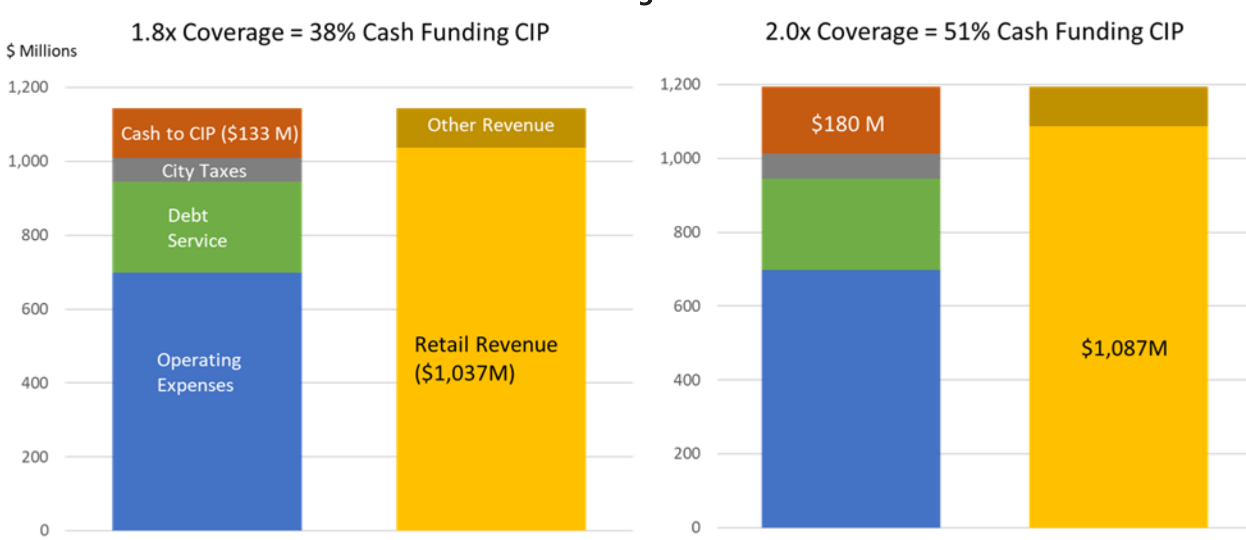
[3] Under City Light's bond ordinances, City taxes have not been included in operating expense for the calculation of debt service coverage since City Light is a department within the City of Seattle and the payments made to the general fund are considered second lien to debt service.

Figure 1



Therefore, higher debt service coverage will increase the amount of operating cash going to the capital program. Figure 2 illustrates how different debt service coverage levels impact the amount of operating cash available for the capital program. Under current conditions 0.2x higher coverage leads to around $50 million more operating cash available for the capital program. This example shows coverage increasing by solely increasing retail revenue (retail rates); however, it is possible to achieve higher coverage with a combination of reductions to operating costs and increases to retail revenue.

Figure 2



In general, higher coverage means less use of debt. It follows that higher coverage, over time, will result in a lower leverage (debt-to-fixed asset ratio). Since the leverage metric is looking at total debt and total fixed assets the impact from higher coverage in any individual year will be small but sustained higher coverage will gradually decrease the debt-to-fixed asset ratio. Maintaining higher cash balances (higher liquidity) will increase the reliance on debt as more operating cash is being held in reserve than put towards the capital program. At current operating expense levels an increase in 50 days cash on hand requires holding on to $106M more cash. This $106M could have been used to reduce the amount of future debt issued. Permanently increasing the DCOH target will result in a one-time impact of increased borrowing.

PEER COMPARIONS OF PROPOSED METRICS

Figure 3 shows comparisons of City Light with 34 peer public utilities for the proposed metrics.[4] The summary includes:

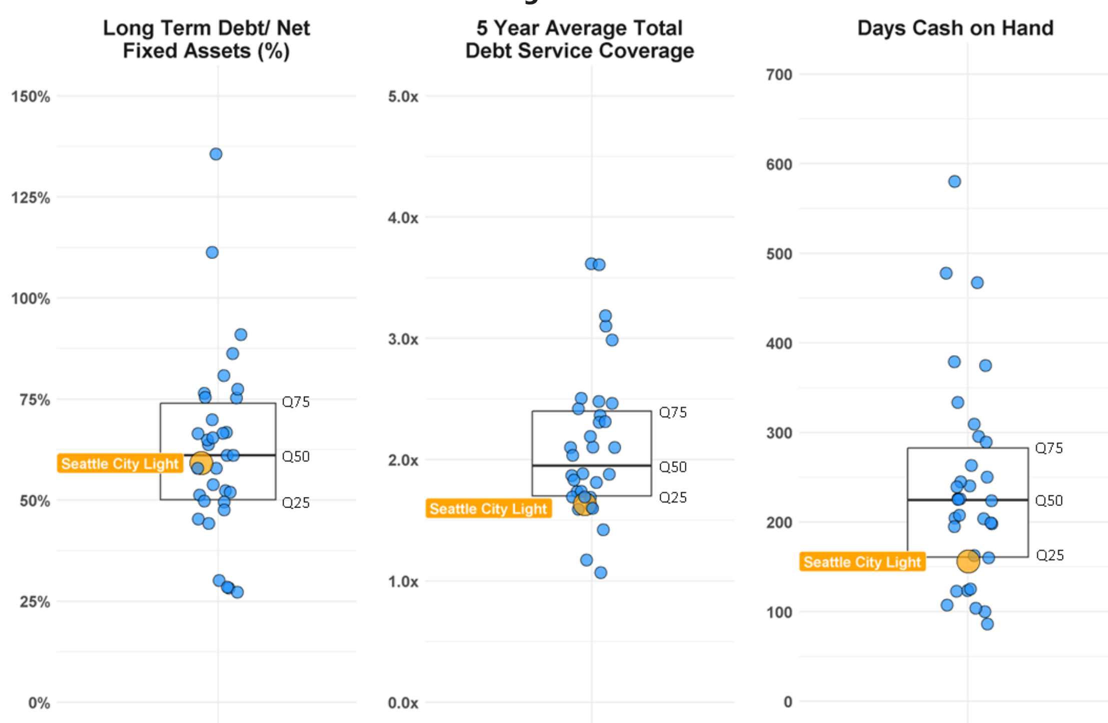
Debt-to-Fixed Assets: City Light is currently close to average compared to other utilities.

Debt Service Coverage: City Light is on the lower side, just under the 25th percentile[5]

Days Cash on Hand: City Light is on the lower side, just under the 25th percentile

More discussion on City Light's relative comparison will be included in the debt strategy proposal section.

Figure 3



4 Data from Moody's Municipal Financial Ratio Analysis (MFRA) system as of October 18, 2022. Reflects public utilities with greater than $200M annual O&M expense who generate 20% or more of their own power requirements and rating in the "A" category or higher (34 utilities in total).

5 Moody's calculation for Total Annual Debt Service Coverage = Net Revenues divided by regular Total Annual Debt Service. This is slightly lower than City Light's calculation of the metric, which removes City taxes when calculating net revenue. For reference removing city taxes from current the debt service coverage calculation adds approximately 0.25x coverage (1.90x is around1.65x with City taxes included in the DSC calculation).

DEBT STRATEGY PROPOSAL

City Light's debt strategy is intended to provide a flexible framework that serves as a guideline for the overall amount of outstanding debt, as well the amount of the capital program that's funded with debt. The strategy establishes metrics and associated minimum targets to help manage debt.

City Light believes it is on the right path of gradually reducing its reliance on debt. In City Light's Adopted 2022-2028 Strategic Plan the rate path was set using a debt service coverage above the existing 1.80x target (six-year average 1.93x). The higher coverage along with managing the size of the capital program resulted in a planning value of funding 40% of the capital program with operating cash. In addition, the current financial outlook has improved since the Adopted 2023-2028 Strategic Plan was developed and current projected capital funding levels from operations are over 40%.

However, while the recent Strategic Plan has put the Utility on the right path, there is no formal debt management strategy that will help guide future plans, ensuring strong financial stewardship for current and future City Light customers.

City Light's proposed debt strategy is summarized as follows:

(1) Update the Debt service coverage target so that rates are set to achieve *at least* 1.80x in any given year and the Utility maintains a 6-year rolling average value greater than 1.90x.
(2) Update Capital Funding target to have greater than 40% of the 6-year average net capital requirements funded with operating cash
    a. Achieved through a combination of capital program prioritization and cost controls and above target debt service coverage, if needed
(3) Introduce a liquidity target of over 150 Days Cash on Hand for setting rates and sizing bond issues.
(4) Introduce a leverage target of less than 60% debt-to-fixed asset ratio.

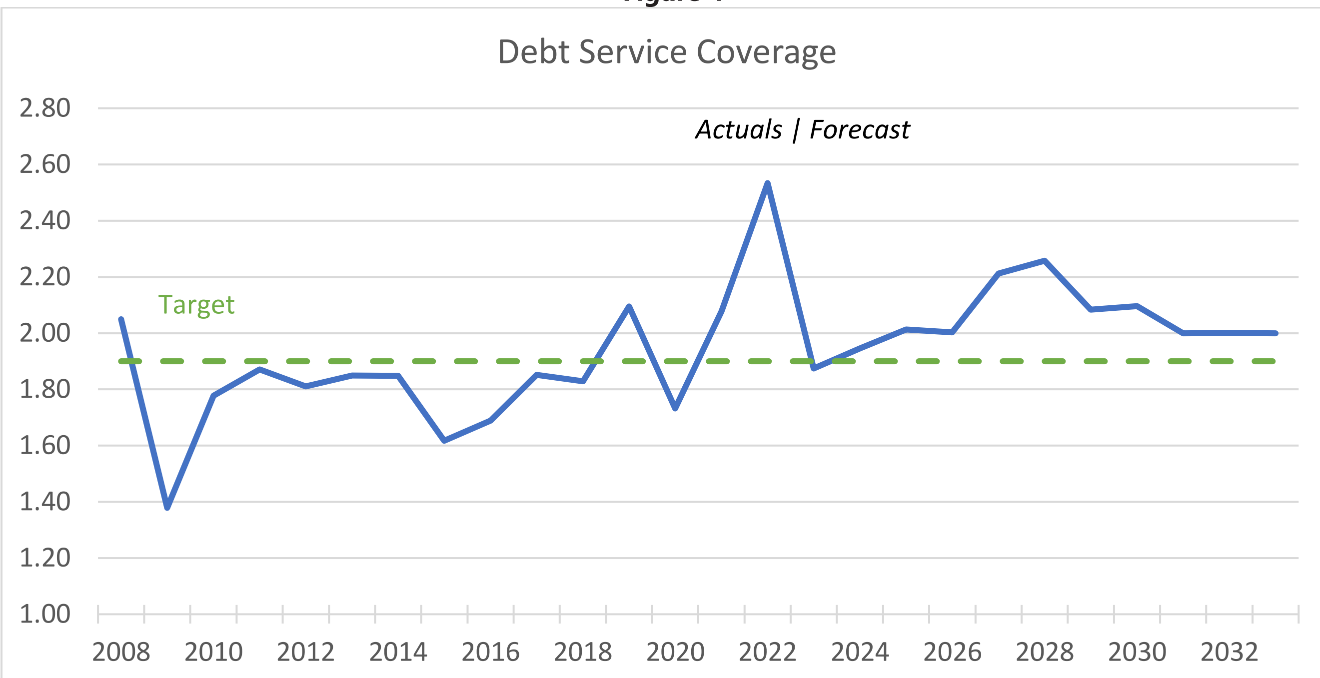
Each component is discussed more below.

Debt Service Coverage. The proposed target of averaging at least 1.90x coverage is a small but material improvement to City Light's current official coverage target of 1.80x each year. In addition, not having a fixed target each year allows for flexibility to smooth out rate impacts over multiple years, including ramping up coverage in anticipation of years of high capital costs. Also, a sustained average coverage of 1.90x is a minimum; actual debt service coverage used to set rates may be higher to meet City Light's other financial policy targets and/or strategic goals.

City Light has relatively low debt service coverage, especially when compared to utilities with similar credit ratings. While City Light's historical coverage is lower than many of its peers, it has many other favorable credit strengths and historically has maintained its high credit rating without ranking in the top half of utilities for debt service coverage (median = 1.95x). In general, higher coverage does mean less debt. However, there is a tradeoff with increasing rates. Every 0.1x increase in coverage means about roughly 2.5% higher customer rates in the near term. The proposed 1.90x or higher coverage on a sustained basis strikes a good balance between financial performance and affordability.

While the policy target is an average of 1.90x per, City Light's specific strategy will be to try to exceed the target and achieve closer to 2.0x coverage on average over the next Strategic Planning period (2025-2030), so long as it can continue to do so with inflation-like rate increases. City Light's annual debt service is currently expected to be relatively flat over the next Strategic Plan period, providing an opportunity for sustained higher coverage alongside modest inflation-like rate increases, all else equal. Figure 4 shows City Light's debt service coverage history and current forecast.

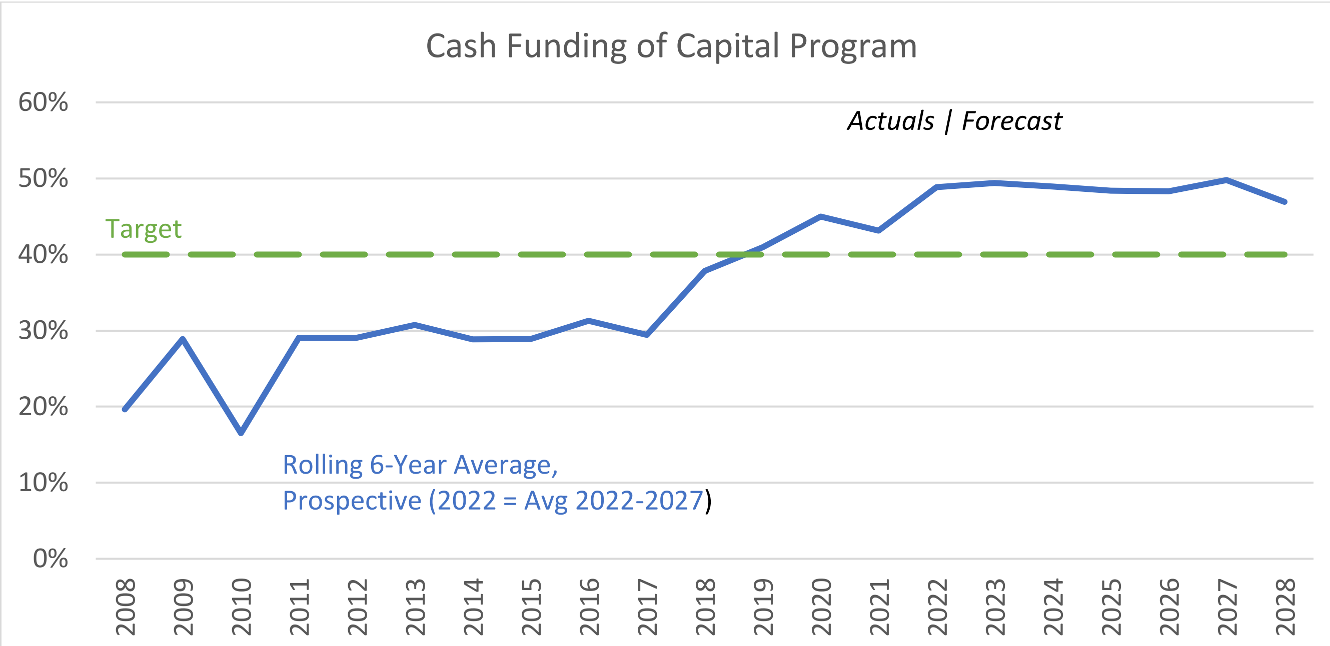
Figure 4



Capital Funding Target. The proposed target is similar to the current policy. The material change is that the funding target is defined as *net* capital requirements, which are after third party contributions. Net capital requirements are the amount of the capital requirements that the Utility is responsible for funding (either through operations or issuing debt). In addition, meeting the 40% funding from operations target can be achieved by a combination of capital program prioritization and cost controls and increasing coverage above the debt service coverage target. The current policy only lists managing the size of the capital program, which may not always be possible given investments required to meet targeted service levels.

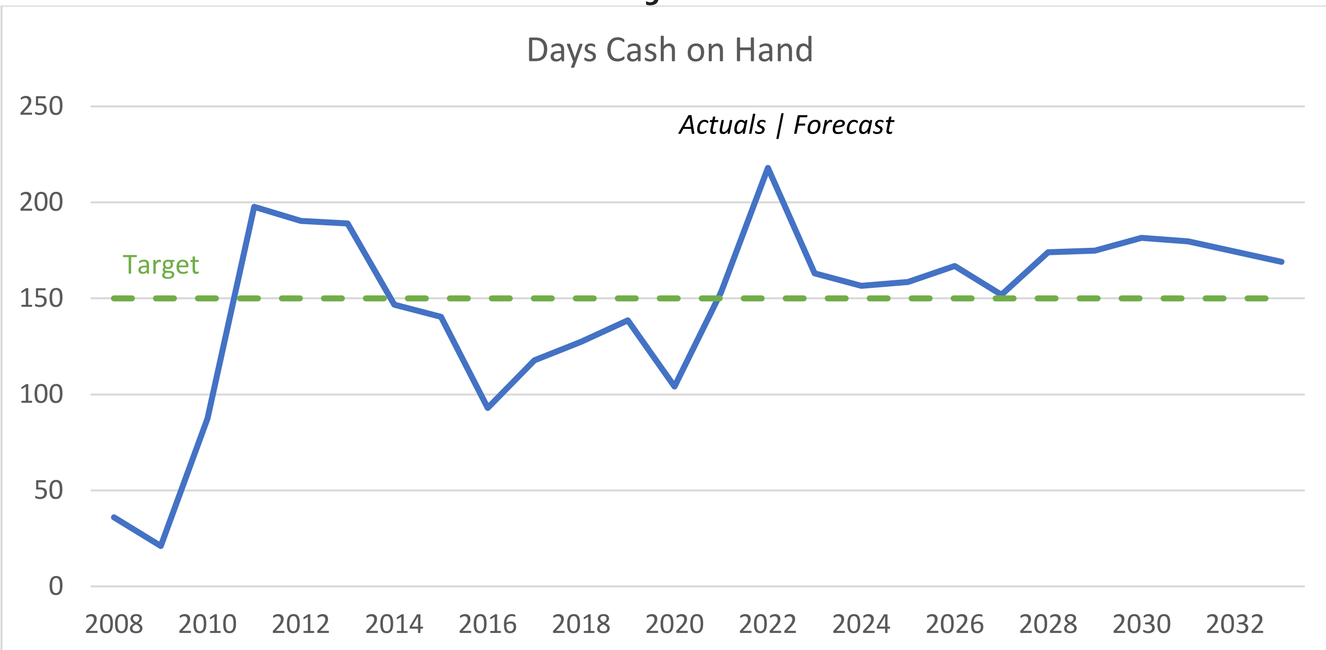
The 40% cash funding policy target is a minimum amount. City Light's strategy will be to achieve greater than 45% in the 2025-2030 Strategic Plan so that the Utility will be able to absorb years of large capital requirements without having to significantly raise rates to meet the 40% minimum funding target. Figure 5 shows City Light's capital funding history and current forecast.

Figure 5



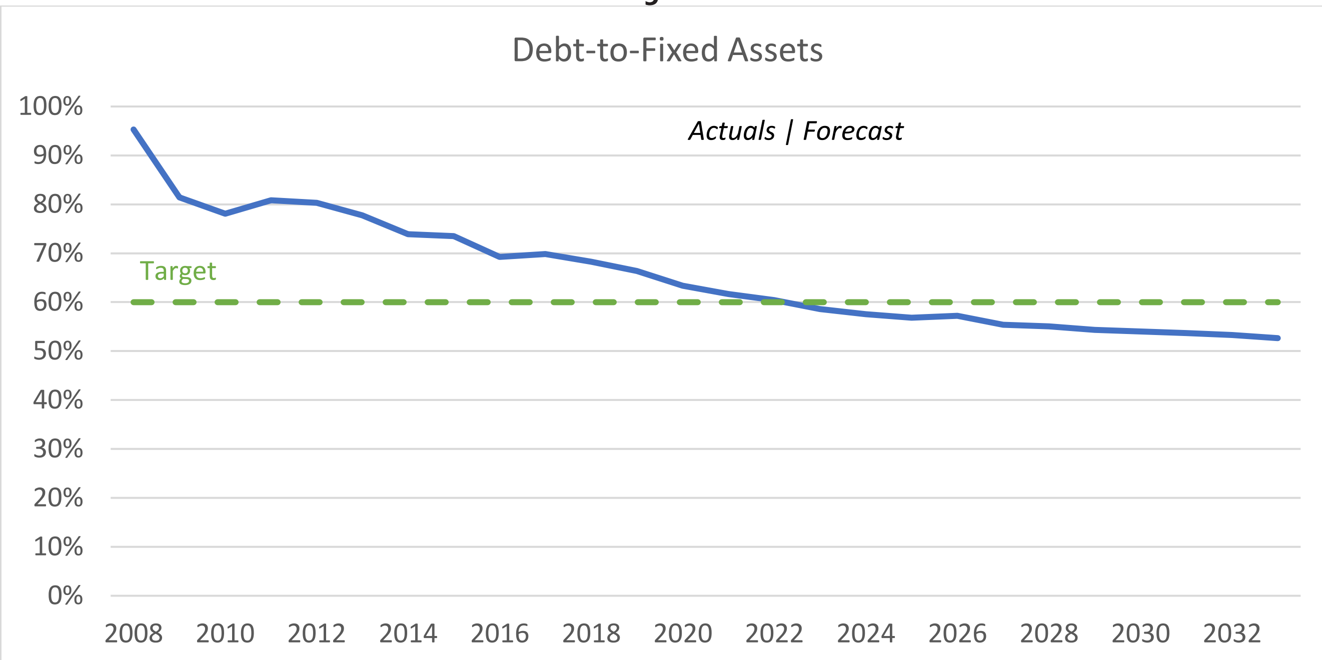
150 Days Cash on Hand. This is a new metric for City Light as the Utility does not currently have an official liquidity target to plan to. Rating agencies typically look at a DCOH metric and note City Light is on the low side compared to similarly-rated utilities. 150 days would be an improvement from historical averages and provide more buffer in years of unexpected cash flow shortages. Since City Light has access to the City's consolidated cash pool in an emergency it doesn't need to carry as much liquidity as other comparably-rated utilities. There is an opportunity cost of carrying higher liquidity as the alternative of reducing debt issuance would result in lower overall costs since long-term borrowing rates are generally higher than short term interest rates. Therefore 150 days will provide sustained improved liquidity but limit the cost of doing so. Figure 6 shows City Light's DCOH history and current forecast.

Figure 6



Debt-to-Fixed Asset Ratio. City Light does not currently have an official leverage metric against which it plans and manages. As mentioned previously, out of all the leverage metrics, the debt-to-fixed assets ratio most closely complements the 40% capital funding target, which is forward-looking. Including a leverage metric as a partner metric to the capital funding target will ensure that the relative amount of debt outstanding is also controlled for. Setting the metric target to less than 60% ensures a manageable debt burden. The strategy will be to gradually bring down the metric below 60% so as to have room to allow it to increase in years of very large capital outlays. City Light has operated with debt-to-fixed capital ratio greater than 60% for many years and still maintained a strong credit rating. However, it will be more prudent to operate with lower debt burden going forward. Figure 7 shows City Light's historical and forecast debt-to-fixed assets ratio

Figure 7



ADDITIONAL FLEXIBILITY

The proposed debt strategy framework allows the Utility to adjust to changing situations. In general, the strategy outlines that City Light should attempt to out-perform each metric target so that it has the required buffer to accommodate years of potential high capital costs without requiring sudden large rate increases to meet its financial targets. However, there could be instances where additional flexibility could be required.

An example of this is if City Light decided to build and own new renewable power generation resources, which would require a significant amount of additional capital. If owning (and debt funding) a generating resource will lead to lower customer rates in the long run the Utility should not avoid ownership because of a large upfront rate increase required to meet financial targets. Therefore, there may be justification to relax the leverage and capital funding targets temporarily, if needed, to allow the Utility to gradually ramp up rates over time.

In most situations the Utility will have sufficient advance notice of new, large capital spending and can gradually increase rates in preparation. However, if there is not enough lead time or if there are other significant rate pressures, the Utility should maintain flexibility to respond to these exceptional circumstances. For example, the Utility might relax its leverage targets for a major one-time expenditure, and would document in writing for City Council what the exceptional circumstance is and how it plans to come back into compliance within a certain number of years and would provide annual reports until compliance is achieved.

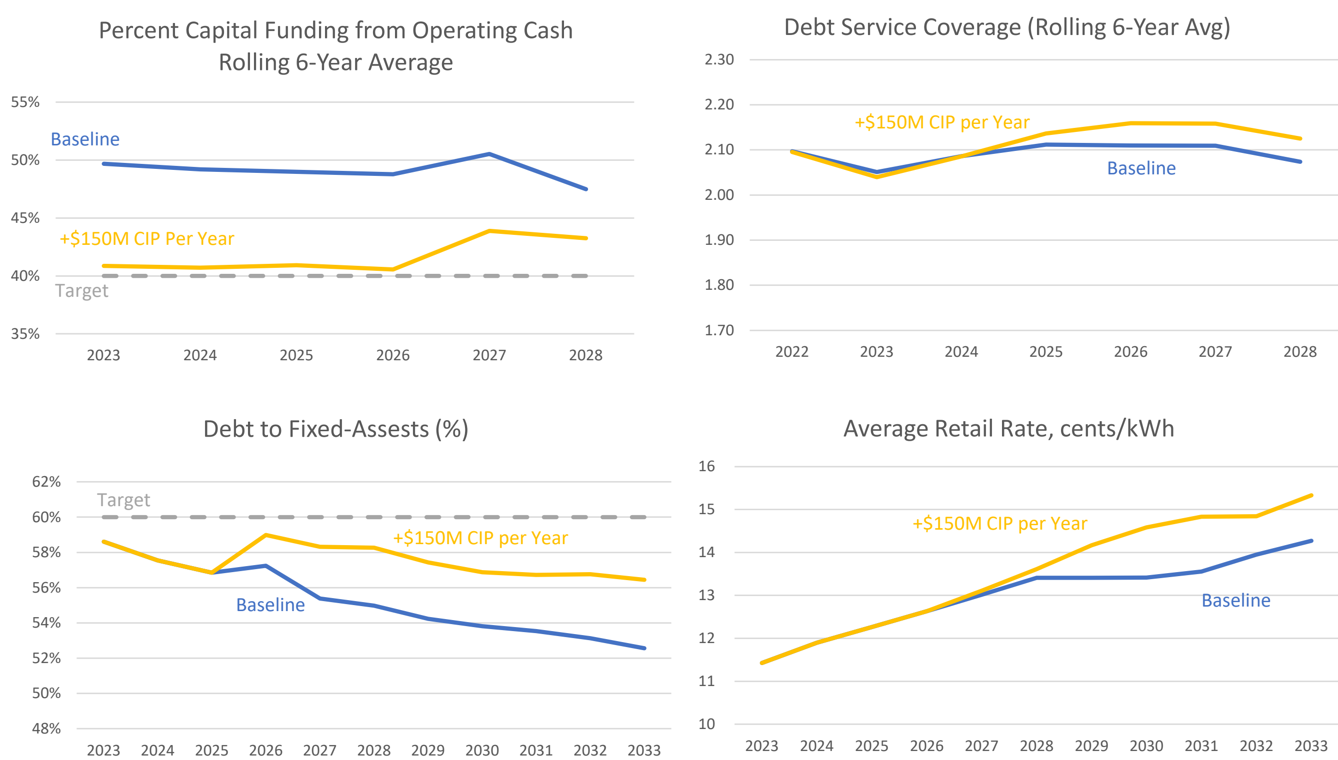
STRESS TEST – SIZE OF THE CAPITAL PROGRAM

A stress test was conducted to see how the size of the capital plan would impact City Light's debt strategy. Under the current financial forecast the Utility is in a strong position to absorb higher capital costs without increasing rates significantly higher than inflation while still meeting the proposed debt targets (>40% capital funding from operations and a debt-fixed-asset ratio <60%).

A number of different capital plan scenarios were run. The most extreme scenario is shared for illustrative purposes. This scenario assumes $150M higher annual capital costs than the baseline each year starting in 2027. For context, $150 million is roughly a third of the size of the baseline (2023-2028 Adopted CIP Plan)

Under the $150M larger capital plan scenario a modest increase in coverage (above baseline) is required to keep the 6-year capital funding target above 40%. The higher coverage along with the higher debt service results in around 8% higher average retail rates over the timeframe. The debt-to-fixed asset ratio was able to remain under the 60% target with no additional intervention above what was required for the 6-year capital funding target. Figure 8 shows the results of the stress test.

Figure 8



DEBT STRATEGY NEXT STEPS

The debt strategy proposes establishing new metrics and targets to provide additional guardrails for prudent debt management. The proposed metrics and targets supplement City Light's existing financial policies. The proposed next steps are as follows:

The new metrics and targets will be used in the development of the 2025-2030 Strategic Plan rate path. Specifically retail revenue should be set at sufficient levels so that:

- Debt service coverage is *at least* 1.80x in any given year and the 6-year rolling average is greater than 1.90x.
- Operating Cash funding is greater than 40% of net capital requirements.
- Days Cash on Hand is greater than 150 days.
- Debt-to-fixed asset ratio is less than 60%.

While the new targets help provide guardrails, the proposed strategies for the specific values used to set retail rates are dynamic and may evolve between Strategic Plan updates based on a variety of factors. The selected metrics will also need to be periodically evaluated and possibly adjusted over time.